in 1970 to the Investment Company Act and their background.

The effects of the alleged conspiracy and combination about which appellant complains are that "sales of mutual fund shares have been confined to a primary distribution system and the growth and development of a secondary dealer market and a brokerage market . . . has been inhibited", and that "the public has been deprived of the benefits of free and open competition" of such markets. (Compl. ¶ 18)

As has been indicated, the price of a mutual fund share is made up of its net asset value and the sales charge or sales load. Since the issuer is obligated to redeem outstanding shares at their net asset value, shares will not be sold by their holders for less than that value. Consequently, any competition would be directed to the amount of the sales load.

The essence of appellant's complaint is that the effects of the present system of selling mutual fund shares, in the language of the court below, is "to cause the public to pay artificial and non-competitive sales loads for mutual fund shares." (Jur. St. App. 31) However, the question of sales charges was a focal point of the amendments enacted in 1970 to the Investment Company Act. These amendments, after 30 years, reaffirmed the unique system of retail price maintenance embodied in Section 22(d) of the Act, and by themselves cut the underpinnings to appellant's approach. In essence, the Congress rejected the conventional, competitive over-the-counter market concept, and refused to throw open to competition the amount of the sales load and, in turn, the price of mutual fund shares.

As will be discussed more fully below, the 1970 amendments were preceded by a Commission report to the Congress that included legislative recommendations as to sale loads. The Congress at great length reviewed this matter, including the absence of a conventional market for mutual fund shares. It considered three alternatives to treat with sales loads, which the Commission had concluded should be lowered. First, as was urged by the Commission, prescribing a maximum sales load in the statute. This was rejected.

Second, the repeal of Section 22(d). This would have permitted the sales load to be determined through competition in a conventional over-the-counter market. Its advocates included the appellant, which recognized that Section 22(d) "prescribes a unique scheme of retail price maintenance for the sales charges levied in distributing mutual fund shares to the public", and urged "that price competition in sales commissions can be allowed with advantage to investors." [3]

Repeal, however, was rejected because, *inter alia,* of a Congressional concern with the adverse effects of a competitive secondary market on the primary distribution system and on the funds themselves. The Congress unequivocally expressed its intention that the sales load fixed by the principal underwriter should be protected from competition both in the primary distribution and in the secondary market for already issued and outstanding shares.

In this connection it should be noted that appellant does make two passing footnote references to the 1970

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[3] The 1969 House Hearings, p. 135, note 38, *infra;* repeated almost identically at p. 136.

amendments in order to criticize reliance thereon by the court below (Jur. St. 16, n. 14, and 20, n. 22). Apart from its incorrect statement that the Commission urged repeal of Section 22(d), appellant, as it does repeatedly elsewhere, fallaciously treats the primary distribution and the secondary market in issued and outstanding shares compartmentally. It fails to perceive the intimate interrelationship of the two in terms of the operation and impact of Section 22(d). Thus, the then chairman of the Commission observed during the House Hearings (p. 713, note 36, *infra*):

> "They [the mutual fund industry] felt that the lifting of section 22(d) would be disastrous for the funds and those who sell them. They said that the dealers who wanted to sell mutual funds would stop buying them from principal underwriters and purchase them at cut prices in the market, and that mutual fund sales charges would thereby be driven down to a point where most dealers would stop selling them at all. In other words, they said the force of competition would reduce the charge.
>
> "They said that as a consequence the existing system of distribution would break down, the underwriters would be unable to make enough sales to offset redemptions, and the funds would be thrown into a net redemption status, and ultimately wither away."

The third approach, which the Congress adopted, was to leave the regulation of sales load as it was, under the aegis of the NASD and Commission, but to prescribe new statutory standards for sales loads in place of the then existing standard, which was found wanting.[4] Im-

[4] Under the 1970 amendments, the NASD has authority to prescribe commissions for mutual fund shares as noted below.

plementation of the amendment is in process, the NASD having made certain proposals. In addition, an exemption from the antitrust laws was specifically impressed into the Investment Company Act. At the same time, the Commission was instructed to make a study of the consequences of price competition if Section 22(d) were repealed. That study has been completed. The Commission held hearings on the matter, at which appellant appeared. The Commission is now formulating its proposals.

In this context, appellant nevertheless decided that it should resort to the antitrust court as the forum for attempting to achieve the policy it had unsuccessfully advocated to Congress in connection with the 1970 amendments, and what it was then urging the Commission to recommend to the Congress or to pursue administratively.

Appellant's utilization of the judicial process should be contrasted with the position it communicated in 1969 to the House Committee (note 38, *infra* pp. 135, 136), which at the time had not yet reported out a bill. Appellant called attention to the fact that the Senate Committee report had stated that the committee lacked adequate information on the consequences of the repeal of Section 22(d) and had requested a report on the subject from the Commission, and that the Senate Committee had made a proposal (which was later enacted) to permit associations of securities dealers to deal with the problem of excessive sales loads. Appellant then stated: "These steps are not inappropriate as interim measures."

PLENARY REVIEW IS NOT NECESSARY

In the setting as just described, it is respectfully submitted that there is no need for the plenary review being sought by appellant. The matter should be left, as the District Court correctly concluded after rejecting appellant's statutory analysis, for resolution under the Investment Company Act in accordance with the program and procedures that the Congress adopted. As the chairman of the Commission recently observed:

> "... The question is not resolved with respect to price competition in the distribution of mutual fund shares.
>
> "You are aware of the fact that the Antitrust Division of the Department of Justice has challenged the present practice of most funds in this regard on antitrust grounds, and the Solicitor General, it was recently reported, has agreed to prosecute an appeal of an adverse decision of the United States District Court in *United States* v. *NASD. We did not think the Antitrust Division should have proceeded on this ground under the antitrust laws, because we think the problem should be resolved as a regulatory matter under the Investment Company Act.* They have not seen fit to comport with our general views, and we may, in the end, have a definitive court determination that will bind all of us, whatver we might otherwise have done.
>
> "In the meantime, our staff is still analyzing the information and arguments provided at the hearings on mutual fund distribution and trying to fashion a proposal. I understand that the staff's proposal is likely to be some middle ground between retention of all of the present practices intact, on the one hand, and the virtual repeal of Section 22(d) on the other. Without expressing any views of my own, I think this is an interesting

> area to explore and we look forward to receiving the staff's proposals shortly." (Emphasis added.)[6]

Additionally, since the statutory provisions here at issue are admittedly unique, there is not presented a matter affecting the overall administration of the antitrust laws.

ARGUMENT

I. The Role of the NASD and the Allegations

In naming the NASD, appellant, as has been indicated, suffered from basic misconceptions. Thus, for example, the complaint (¶ 17) alleges that to effectuate the alleged combination and conspiracy the NASD

> "(a) established and maintained rules which inhibited the development of a secondary dealer market and a brokerage market in mutual fund shares;
>
> "(b) established and maintained rules which induced broker/dealers to enter into sales agreements with principal underwriters, with knowledge that sales agreements contained restrictive provisions which inhibited the development of a secondary dealer market and brokerage market in mutual fund shares;"

In the court below, in its memorandum and reply in support of its motion to dismiss, the NASD pointed out: (1) that under the Maloney Act, the forum for any attack on NASD rules was not the courts but rather the Commission, which had exclusive jurisdic-

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[6] Address by Ray Garrett, Jr., entitled "Mutual Funds: Fifty Years and Beyond", May 15, 1974.

tion of the matter, (2) that like all its rules, the one NASD rule—Section 26 of the NASD Rules of Fair Practice—dealing with the distribution of mutual fund shares, had been specifically cleared by the Commission under statutory provisions that contain antitrust standards, and (3) that the NASD rules enjoyed antitrust immunity. Furthermore, the NASD reviewed in detail the aforementioned Section 26, which made it clear that there was no warrant for appellant's allegations.

Confronted with these considerations, at the oral argument, appellant repudiated the foregoing allegations. It announced, as it later confirmed by letter to the court, that the complaint was not attacking any NASD rules. This also is appellant's current position and dilemma. Indeed, appellant acknowledges that none of the NASD rules requires or necessarily results in suppression of the secondary brokerage or interdealer markets. (Jur. St. 26)

In this connection it may be noted that following oral argument, the court below invited the Commission to participate in the case. The Commission advised the court by letter[6] that it would likely participate if appellant was attacking the NASD rules, but as already indicated appellant had abandoned its attack. In its letter (pp. 2-3) the Commission summarized the Maloney Act as follows:

> "The Maloney Act was enacted to encourage the formation of self-regulatory organizations; . . . Congress contemplated that the Securities and Exchange Commission would 'exercise appro-

[6] Letter of August 9, 1973, from Lawrence E. Nerheim, the Commission's general counsel.

priate supervision in the public interest' over the activities of these self-regulatory organizations and further granted to the Commission 'supplementary powers of direct regulation.' Accordingly, in order for an association of over-the-counter broker-dealers to be registered under the Maloney Act, the Commission has to find that the association's rules meet a number of standards specified in Section 15A(b), including that they are *designed 'to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers* . . .,' Section 15A(b)(8). In the same manner, for a registered association to amend its rules, the Commission must find, under Section 15A(j), that the amendment is consistent with the standards of Section 15A(b). And Section 15A (k)(1) of the Act authorizes the Commission, 'after appropriate notice and opportunity for hearing,' to abrogate rules of a registered association, 'if such abrogation is necessary or appropriate to assure fair dealing by the members of such association . . . [or] to protect investors or effectuate the purposes of this title.[3]' Among the purposes of the title are the *competitive considerations* contained in Section 15A(b)(8). Finally, Section 15A(n) of the Maloney Act provides that:

'If any provision of [the Maloney Act] . . . is in conflict with any provision of any law of the United States in force on the date this section takes effect, the provisions of this section shall prevail.' " (Emphasis added.)

"[3] The Commission's authority under 15A(k)(1) extends to partial abrogation of a rule of a registered association insofar as the rule has been interpreted or applied by the association in a manner inconsistent with the purposes of the Maloney Act. *See* Securities and Exchange Commission, Securities Exchange Act Release No. 9632 (June 7, 1972)."

The letter (p. 4, n. 5) refers to Section 15A(n) as an "express antitrust exemption." See *United States* v. *Socony-Vacuum Oil Co.,* 310 U.S. 150, 227, n. 60; *International Association of Machinists* v. *Street,* 367 U.S. 740, 809-10, n. 16 (dissenting opinion).

The letter (p. 3), in continuing its description of the statute, stated:

> "The Maloney Act thus vests in the Securities and Exchange Commission broad regulatory authority over the rules of registered over-the-counter broker-dealer associations like the NASD, and provides for precise standards and procedures to be employed by the Commission in authorizing or reviewing those rules."[7]

Confronted with the fact that the keystone of its attack on the NASD has been pulverized, appellant relies on what it characterizes as "purported NASD interpretations of its rules communicated to its members but not submitted to or reviewed by the Commission." (Jur. St. 27). To support this sweeping charge, with its ring of multiplicity and frequency, appellant has been compelled to reach back 15 years to cull out an isolated item from the reams of material that had been submitted to it by the NASD. The incident, narrated as if it involved the clandestine intrigue of a cabal, is described in ambiguities which conceal what actually transpired (Jur. St. 27, n. 31).

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[7] The letter (p. 4) also pointed out that if this litigation does "in fact constitute attacks on matters which are within the Commission's supervisory jurisdiction over NASD rules then the teaching of *Ricci* [v. *Chicago Mercantile Exchange,* 409 U.S. 289, 302-303, n. 13] and the very structure of the Maloney Act require you to conclude that these cases cannot be maintained under the antitrust laws." This observation is equally applicable to NASD rules under the Investment Company Act.

The vintage incident, a letter of June 22, 1959, has, as a result of lack of any remaining postulate of wrong, become the strand on which appellant hangs its case against the NASD.[8] Despite its irrelevancy, the letter merits some elaboration in view of appellant's overtones of impropriety which also spring from misconception.

At the outset it should be emphasized (1) that this letter to NASD members dealt with the primary distribution of shares emanating from the issuer and not the secondary market in previously issued and outstanding shares, and (2) that the letter did not in any way affect the price paid by the investor. It dealt with non-contract dealers participating in a primary distribution. Under any reading of Section 22(d), as appellant recognizes, such non-contract dealers must sell to an investor at the public offering price.

The letter was openly and widely distributed and described as well in the NASD monthly newsletter to its members.[9] It dealt with the situation of dealers with selling group agreements who took down shares from the underwriter to fill orders—at a discount from the public offering price—from other dealers who were not parties to the selling group agreement. As indicated in the letter, this practice permitted a non-contract dealer to evade the requirement of Section 26(c) of the NASD Rules of Fair Practice that dealers in the primary distribution have a selling group agreement with the underwriter, which the Commission had

[8] The letter (GX-18) was one of 30 exhibits included in an affidavit filed below by appellant. The NASD offered no evidence.

[9] Such material is routinely sent to the Commission. See Rule 15Aj-1(d) adopted by the Commission under the Maloney Act, 17 C.F.R. 240.15Aj-1(d).

cleared.[10] While this requirement affected non-contract dealers, so does the section's provision relating to redemptions. It was cleared by the Commission over the objections of such dealers that the provision "creates unfair discrimination."[11] Pointing out that mutual fund shares are "a peculiar type of security", the Commission observed:

> "The nature of these shares and the manner in which they are distributed and redeemed are so extraordinary as perhaps to justify extraordinary treatment."[12]

Promulgation of the letter was done neither in stealth nor in violation of any procedures, as appellant suggests.[13] The letter had the following genesis: The NASD committee handling the matter had proposed an interpretation of Section 26(f)(2) of the NASD Rules of Fair Practice which would have prohibited contract dealers from taking down investment

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[10] In passing upon Section 26, which deals with the primary distribution and redemption of mutual fund shares, the Commission pointed out that Section 26(c) "in effect requires . . . [a selling] agreement by providing that a member of the Association who is a principal underwriter may not sell to another member at a concession from the public offering price unless a sales agreement is in effect between the parties". *National Association of Securities Dealers, Inc.*, 9 SEC 38, 44 (1941).

[11] *Ibid.* p. 44.

[12] *Ibid.* p. 45.

[13] As another of its misconceptions, appellant urged below that the letter required approval of the NASD membership. Having been advised below by the NASD that this was not required in view of *National Association of Securities Dealers, Inc.*, 17 S.E.C. 459, 465 (1944), appellant here has refrained from this specific contention, but not the overtones of procedural deficiency, of which there were none.

company shares from underwriters except to fill orders from members of the public (GX-16 and 17, see note 8, *supra*).[14] The matter was discussed informally by NASD representatives with the Commission staff on March 11, 1959. According to the latter's memorandum of conference (GX-6), the staff objected to the proposed step, which the memorandum stated was to take the form of a proposed interpretation of Section 1 of Article III of the NASD Rules of Fair Practice. That section provides that a "member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." The memorandum of conference, while stating that the Commission staff advised that "the statute"

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[14] The June 22, 1959 letter suggested amendment of selling group agreements to the effect—and it should be added as they ordinarily do—that shares (other than for bona fide investment by the dealer) may be taken down at a discount only to fill orders in hand from members of the public. Section 26(f)(2) of the NASD Rules of Fair Practice prohibits a member (other than a dealer buying for his own investment) from purchasing shares from the issuer or underwriter except "for the purpose of covering purchase orders already received." While Section 26(f)(2) does not specifically state that the orders must be received from members of the public, such must have been the intent in light of its purpose. Section 26(f) "is designed to eliminate any extra undisclosed profits by dealers and underwriters at the expense of the issuers and/or investors", as the NASD explained at the Commission hearing on the rule before it became effective. Public Conference on a Proposed Amendment to the Rules of Fair Practice of the National Association of Securities Dealers, Inc., March 28, 1941, pp. 9-10. If Section 26(f) were not construed as referring to orders received from the public, non-contract dealers who purchased through the contract dealer could "inventory" the shares and derive profits at the expense of the existing security holders, which Section 26(f) was intended to deny.

The letter further pointed out that strict enforcement of selling group agreements will also serve to remedy the situation.

did not prevent a contract dealer from taking down shares from an underwriter for a non-contract dealer, also states that the staff advised "that selling group agreements could and often did bar such transactions, [and] that it was hardly the function of the NASD to enforce selling group contract provisions (the PSI case was referred to)."

What evidently concerned the Commission staff was the use of NASD disciplinary procedures to enforce selling group agreements.[15] But even before the meeting with the Commission staff, the NASD Board of Governors had advised the NASD committee which was handling the matter that the Board "does not want to be in a position of enforcing selling group agreements." (GX-16)

The letter of June 22, 1959 was accordingly wholly consistent with the advice received from the Commission staff.[16] It was warranted as well by the NASD

[15] The "statute" referred to in the Commission staff memorandum of conference is not identified, but when read together with the reference to the PSI case, the "statute" would seem to be the Maloney Act. The PSI case referred to was *National Association of Securities Dealers, Inc.*, 19 S.E.C. 424 (1945). In that case a majority of the Commission held that, in view of Section 15A(b)(8), NASD members who breached the price maintenance provisions in a conventional underwriting agreement were not subject to NASD disciplinary action for a violation of above mentioned Section 1 of Article III of the NASD Rules of Fair Practice. The Commission's conclusion was not predicated on impropriety of the price maintenance provision, but rather on its view that the Maloney Act did not contemplate "a new form of compulsion", i.e., NASD sanctions, to achieve compliance with the contractual provision involved. 19 S.E.C. at 443.

[16] The NASD summary of the Commission staff conference (GX-16) states in part: "The [Commission] staff also said that it felt that investment company underwriters should amend their selling group agreements to cover the point involved, if they so desire, and enforce the contracts themselves."

rules, as has been indicated.[17] There was no reason to keep the matter secret from the Commission; nor was it.[18]

In the face of this record—with a complaint, conceived in obvious misunderstanding, that appellant repudiates in its essentials, and which it seeks to resuscitate by reference to an irrelevant, vintage incident that was wholly warranted—appellant unabashedly closes its Jurisdictional Statement (p. 28) with a flourish and, using the broad brush, asserts that "appellees' activities", which, of course, includes the

[17] In this connection it may further be noted that an NASD letter (GX-22) included in appellant's affidavit below, which relates to the filling of orders by a non-contract dealer, analyses the matter as above stated, and then concludes that if the non-contract dealer "is not willing to arrange for a selling agreement . . . the most practical course . . . is to obtain the shares in the open market from . . . whoever makes the best market in such shares . . ."

[18] Appellant mentions (Jur. St. 8), but never elaborates on the reference in the complaint to suppression of market quotations. It is well advised, for it would suffer more of the frustration it has already experienced in attempting to mold an antitrust action on matters within the exclusive jurisdiction of the Commission. There is a network of statutory regulation to assure the integrity of quotations. Under Section 15A(b)(12), 15 U.S.C. 78o-3(b)(12), the NASD is required, as it has, to adopt rules "designed to produce fair and informative quotations, both at the wholesale and retail level, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting and publishing quotations." See, e.g., NASD Rules of Fair Practice, Art. III, Sections 5 and 6. These rules are subject to the Commission clearance and oversight under the Maloney Act as discussed earlier. In addition, the Commission itself is specifically authorized to regulate the matter of quotations under Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78o(c)(2). This is in addition to the general anti-fraud provisions of the Securities Exchange Act, which arm the Commission with direct regulatory authority, that would reach "suppressed" quotations, as would Section 1, Article III of the NASD Rules of Fair Practice previously referred to.

NASD, "have resulted in the elimination of secondary brokerage and inter-dealer markets and in the fixing of prices and commissions on all mutual fund transactions . . ."

Competition is the theme of the complaint, but this is not the thesis of Section 22, to which we now turn.

II. Section 22 of the Investment Company Act

Section 22 of the Act, 15 U.S.C. 80a-22, which is set out in the Appendix, deals with the sale and redemption of mutual fund shares. It embodies a unique regulatory pattern that encompasses the price at which mutual fund shares are to be sold both on a primary distribution and thereafter. The statute deals specifically with each of the two components that make up the price of a mutual fund share, i.e., net asset value and sales load.

1. Section 22(a) has remained unchanged since the Act was passed in 1940. In substance, it authorizes the NASD to adopt rules to protect existing shareholders from a dilution of their equity or other unfairness so that the "minimum price" at which shares may be purchased from a mutual fund (and also the "maximum price" which it may pay on redemption) is in "relation to the current net asset value" of the security.

Section 22(b) by its terms deals with the sales load on a primary distribution, but its impact carries over to the secondary market in issued and outstanding shares, as discussed below. Prior to the 1970 amendments, Section 22(b) in substance authorized the NASD to adopt rules so that the offering price would "not include an unconscionably or grossly excessive sales load." The 1970 amendments, which are fully

explored below, continued the NASD rule making authority but the standard was changed so that the offering price "shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors." [19]

NASD rules become effective only after they have been passed upon by the Commission in terms of compliance with Section 22 and also the applicable standards of the Maloney Act, as has been indicated. In addition, the Commission exercises continuing oversight with respect to the NASD rules, and it may adopt rules superseding or supplementing NASD rules. [20] Thus, in effect, the Commission has exclusive jurisdiction of the matter. [21]

The 1970 amendments also added Section 22(b)(4) to the statute which, in terms identical with Section 15A(n) of the Maloney Act, provides for antitrust immunity. [22]

Section 22(d) of the Act provides for retail price maintenance. The pertinent provision of Section 22(d), which has remained unchanged since the passage of the statute in 1940, provides:

> "No registered investment company shall sell any redeemable security issued by it to any person

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[19] The amended Section 22(b) relieves such rules from compliance with Section 15A(b)(8) of the Maloney Act to permit rules prescribing methods for computing, and limitations on, sales loads.

[20] Section 22(b)(3) and 22(c) of the Investment Company Act.

[21] Section 25(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78y(a), provides for review of Commission orders by the Circuit Courts of Appeal.

[22] Senate and House Reports, note 39, *infra*, at pp. 18 and 30, respectively.

> except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter, or the issuer, except at a current public offering price described in the prospectus."

Section 22(d) is of general application. It draws no distinction between newly issued shares in a primary distribution and transactions in the secondary market in already outstanding shares. Nor are its proscriptions limited to those who have selling group agreements. As long as a mutual fund is offering shares—and this is the common situation—Section 22(d) applies. It should also be noted that while Section 22(b), which as pointed out above deals with the sales load, is cast in terms of the primary distribution, it is the load permitted under Section 22(b) together with the per share net asset value which determine the public offering price that must be maintained under Section 22(d), even in the secondary market.

It should be emphasized that notwithstanding possible contrary intimations by appellant (Jur. St. 2, 15 n. 13, 16-18), it acknowledges that the retail price maintenance provisions of Section 22(d) apply to non-contract dealer transactions in the secondary market for already issued and outstanding shares. Speaking of those markets and the non-contract dealer, appellant states (Jur. St. 11, n. 8):

> "This market does not produce any monetary advantage to a 'buying' investor, since all dealer

sales to investors, under Section 22(d), must be made at the fixed public offering price so long as the same class of share is being offered to the public by the fund or its underwriter."

2. The objectives of Section 22(d) have been explained by the Commission time and again in the following terms, with which appellant disagrees:

"... the purposes of Section 22(d) as stated by the Commission 'are to prevent discrimination among purchasers and to provide for orderly distribution of such shares by preventing their sale at a public price less than that fixed in the prospectus.' [citing Investment Company Act Release No. 2798 (December 2, 1958)] ... Section 22(d) seeks to prevent the adverse effect upon investors generally which would result from discriminatory pricing and disorderly distribution."[23]

Prior to the passage of the Act, the so-called "bootleg market" provided over-the-counter price competition in outstanding mutual fund shares. This competition existed between contract dealers, who had distribution agreements with the principal underwriters and were obligated to sell fund shares at sales loads fixed by the principal underwriter, and dealers who did not have such an agreement and obtained shares from sources other than the principal underwriter, reselling them at whatever price they chose. This caused dealers to cancel their contracts with principal underwriters. As described in the Commission study that led to the passage of the statute initially, these non-contract

"dealers would often offer a little more than the published redemption price and ask a little less

[23] *Spiro Sideris,* Securities Exchange Act Release No. 8816 (February 13, 1970).

> than the published sale price . . . Such operations actually had the effect of initiating a small scale price war between retailers and tended to disrupt the established offering price."[24]

The response to this competitive situation was Section 22(d) which came about in the following circumstances: The original bill recommended by the Commission did not contain this provision. Extensive Senate hearings were held on that bill,[25] and the industry, while not opposing legislation, did not agree with the Commission's proposals. A spokesman for the industry suggested the framework of an acceptable bill.[26] With respect to Section 22, he stated that it

> ". . . should also provide that no securities issued by an ivestment company shall be sold to insiders or to anyone other than an underwriter or dealer except on the same terms as are offered to other investors."[27]

This proposal, almost in verbatim language, was again set forth in a memorandum agreement between the Commission and the industry.[28] This agreement produced a compromise bill[29] that included Section 22(d)

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[24] Investment Trusts and Investment Companies, Report of Securities and Exchange Commission ("the Commission Investment Trust Study"), Part 3, p. 865; see also Part 2, p. 241, n. 100.

[25] Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 76th Cong., 3d Sess. on S. 3580 (1940).

[26] *Ibid.*, p. 1053.

[27] *Ibid.*, p. 1057.

[28] Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce, H. Rep. 76th Cong., 3d Sess., on H.R. 10065, p. 99.

[29] *Ibid.*, p. 96.

and was enacted. The Senate Committee Report on that bill states:

> "In addition, provision is made to prohibit the sale of redeemable securities to any person other than a dealer or principal underwriter at a price less than that at which the security is sold to the public." Sen. Rep. No. 1775, 76th Cong., 3d Sess., p. 16.

Notwithstanding the evident breadth of the foregoing statements, appellant urges (Jur. St. 18, n. 19) that they "do not purport to apply to sales in a secondary market". But, nevertheless appellant acknowledges, see p. 22, *supra,* that Section 22(d)—the purpose and intent of which reflects these statements—embraces transactions in the secondary market in already issued and outstanding shares by both contract and non-contract dealers.[30]

The Commission's Investment Trust Study (Part 3, p. 865) pointed out that certain mutual funds attempted to overcome the price competition of the "bootleg market" by restricting the negotiability of their shares and providing that they could only be sold or tendered for redemption to the mutual fund. Section 22(f) of the Act permits restrictions on transferability and alienability, subject to certain disclosures

[30] Appellant highlights (Jur. St. 18) a statement in the House Committee Report. The statement, as a full summary of Section 22(d), is incomplete on its face, as appellant must recognize in light of its acknowledgement that Section 22(d) embraces transactions in the secondary market in issued and outstanding shares. The statement (H. Rep. No. 2639, 76th Cong., 3d Sess., p. 20) is: "Subsection (d) prohibits [to make its argument appellant is compelled to present the statement as if the word "only" appeared at this point] investment companies from selling their redeemable securities to any person other than a dealer or principal underwriter at a price less than that at which the security is sold to the public."

and Commission rule making authority, which has not been exercised.

In addition to the references in the 1940 legislative materials to the "bootleg market" as the framework of Section 22(d), such references abound in the wholly relevant legislative history of the 1970 amendments discussed below.

It should be added that the "bootleg market" was an "inside" inter-dealer market and not a brokerage market.[31] An indispensible ingredient of the over-the-counter markets are the so-called "market makers" who serve as conduits and make the over-the-counter markets viable. They buy and sell as principal for their own account and maintain inventories in the particular securities in which they make a market. When a customer expresses an interest in buying or selling a security to the securities firm with which he deals, that firm, whether it is acting as a broker or dealer, will ordinarily look to the market maker to obtain or dispose of the customer's securities as the case may be. On its face, Section 22(d) reaches such investor purchases.[32]

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[31] The Commission Investment Trust Study, Part 2, p. 241, n. 100 and p. 327.

[32] In view of the emphasis placed by appellant on the terms "broker" and "dealer" (Jur. St. 15), it is interesting to note that the Commission's Investment Trust Study (Part 3, pp. 857-859) in discussing trading practices, used the term "dealer" in a generic sense, and the capacity in which the dealer was acting was delineated by references to "the dealer acting as principal" and to "the dealer acting as agent." This is reflected as well in the Senate Report on the 1970 amendments (note 39, *infra,* at p. 8), which speaks of the "dealer [that] acts as principal." The dealer in a primary distribution, as previously pointed out, can take down

Similarly, the secondary market for mutual fund shares since the passage of the Act has been an inter-dealer market. As is pointed out in a recent Commission staff study referred to by appellant, "the inter-dealer firms do not deal directly with the public." [33]

The secondary market since 1940 has diminished. But this, of course, was the intended purpose of Section 22(d). But, as the recent Commission staff study pointed out, the diminution has also resulted from other independent factors. [34]

3. In 1966 the Commission submitted a report to the Congress in which it recommended statutory amendments in light of the developments that had taken place since the passage of the Investment Company Act in 1940. Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth (1966) ("the 1966

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shares only for orders he has already received, and he is designated as a "dealer" for the purpose of insulating the issuer and underwriter from liabilities for his acts. Except to the extent that it "inventories" mutual fund shares, a securities firm, whether it acts as a "dealer" or as a "broker", performs the same market function and bears essentially the same risk.

[33] See note 45, *infra.*, Part II, p. 293.

[34] These included, for example, the disappearance of the redemption fee that mutual funds at one time charged and a lessening of the percentage of the sales load retained by the principal underwriter, which have both had the effect of reducing the spread between the redemption value of shares, and the price charged to retail dealers, thereby in turn reducing the non-contract dealer's incentive to seek out selling shareholders rather than purchase shares from the underwriter on a primary distribution. See note 45, *infra.*, Part 2, pp. 290-294.

Commission Report")[35]. The Commission's recommendations were embodied in bills introduced in the 90th Congress. In 1967, hearings were held before the committees of both the Senate and the House of Representatives.[36] The Senate Committee reported out a bill[37], which was passed by the Senate. The House Committee took no further action.

In the 91st Congress, bills were again introduced, and further committee hearings were held on both sides of the Congress.[38] This time bills were reported out by both committees,[39] and following a conference[40], the amendments were enacted in 1970, Public Law 91-547. It may be noted that both the House and Senate bills (as was true also of the Senate Bill passed in the prior Congress) subjected sales loads to regulation by the NASD and the Commission, as embodied in

[35] Printed as H. Rep. No. 2639, 89th Cong., 2d Sess.

[36] Hearings before the Committee on Banking and Currency, U.S. Senate, 90th Cong., 1st Sess., on S. 1659; Hearings before the Subcommittee on Commerce and Finance of the Committee of Interstate and Foreign Commerce, House of Representatives, 90th Cong., 1st Sess., on H.R. 9510, H.R. 9511. Referred to as "1967 Senate Hearings" and "1967 House Hearings", respectively.

[37] S. Rep. No. 1351, 90th Cong., 2d Sess.

[38] Hearings before the Committee on Banking and Currency, U.S. Senate, 91st Cong., 1st Sess., on S. 34 and S. 296 (1969); Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, 91st Cong., 1st Sess., on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737. Referred to as "the 1969 Senate Hearings" and "the 1969 House Hearings", respectively.

[39] S. Rep. No. 91-184; H. Rep. No. 91-1382. Referred to as "the Senate Report" and "the House Report", respectively.

[40] H. Rep. No. 91-1631.

Section 22(b); their differences related to matters not here relevant.[41]

The 1966 Commission Report to the Congress called attention (p. 42) to the fact that there was only a small trading market for mutual fund shares. The report reviewed at great length (pp. 201 ff.) the entire subject of the distribution of mutual fund shares, and particularly the sales load. While the Commission was of the view that existing sales loads should be lowered (pp. 221, 222), it indicated (p. 218) an inability to act under the then existing statutory standard proscribing "unconscionable or grossly excessive" sales loads.

Then the report (pp. 218 ff.) dealt at length with retail price maintenance. Section 22(d) was referred to as one of the "statutory controls with respect to sales loads". It was pointed out that Section 22(d) "effectively prevents any price competition among dealers", and requires them to "adhere rigidly to the offering price whether the shares they sell are newly issued or already outstanding" (p. 218). Next, the background of Section 22(d) was explained (p. 219) in terms of the "bootleg market" and its consequences, basically as set forth herein earlier. It was then emphasized that Section 22(d) is unique and is "an exception to the general rule that in the over-the-counter markets charges for executing transactions are subject to negotiation" (p. 219).

The report then addressed itself to possible methods of achieving the lower sales loads that the Commission sought. The report considered the elimination of Section 22(d), pointing out (p. 222) that the advantage of such a step would be that it "would allow the proper

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[41] *Ibid.*, p. 28.

level of sales loads to be determined by the freely active forces of retail price competition." The Commission rejected this approach because it could result in price discrimination in favor of knowledgeable investors (p. 222).[42]

The Commission then advocated establishing maximum loads, and recommended in essence that "[s]ales charges for mutual fund shares may not exceed 5 percent of their net asset value at the time of sale." In this connection the Commission observed (p. 223):

> "Moreover, the mutual fund industry has operated for over a quarter of a century under the anti-competitive protection against price competition afforded by section 22(d). A maximum sales load would avoid any unsettling and unforseeable effects which abolition of retail price maintenance might have on the broker-dealer community . . ."

At the outset of the 1967 Senate Hearings (note 36, *supra*) the Committee Chairman observed (p. 1) that the Commission's report "correctly emphasized the serious problems" that had arisen since 1940, "especially in the area of mutual fund sales commissions . . ." The chairman of the Commission referred to sales charges as a "major" problem that had "received the greatest attention" (pp. 5, 25, see also p. 126). His presentation essentially repeated the observations and recommendations in the 1966 Commission Report previously summarized. He pointed out (at pp. 25-26), for example:

> "mutual fund sales charges are not determined by the normal interplay of free market forces,"
>
> * * *

[42] The Commission also thought elimination of Section 22(d) might at least temporarily favor captive organizations, which are not involved here, that are the sole distributors of the fund shares they sell (p. 222).

> "It [Section 22(d)] permits the fund's principal underwriters to fix sales charges and then requires the Federal Government to enforce adherence to those prices by every retail dealer whether or not he has a contract with the underwriter and whether or not he is engaged in the initial distribution of the fund's shares."
>
> * * *
>
> "Sellers of mutual fund securities have been insulated by Federal law from price competition at the retail level since 1940."

This was elaborated upon in a written statement he presented (pp. 142-155), with references to Section 22(d) and the pre-1940 "bootleg market" (pp. 151, 153), and a repetition of the reasons set forth in the 1966 Commission report for its not advocating competition, but a prescribed maximum sales load (p. 154).

The Commission made a similar presentation at the 1967 House Committee Hearings, e.g., pp. 48-61, 94, 109-114, 142-143.

There were those that urged the repeal of Section 22(d). For example, in 1967 appellant, as it did again more forcefully in 1969 (see p. 7, *supra*), urged that the small investor "should not perhaps be deprived of the opportunity of purchasing his investment at a price arrived at through the free operation of competitive forces." 1967 House Hearings, p. 21.

Similarly, Professor Paul A. Samuelson urged repeal of Section 22(d) so that "there would spring up a secondary market for . . . mutual funds." 1967 Senate Hearings, pp. 348, 356, 366; see also 1969 Senate Hearings pp. 55, 58, 64.

The views expressed to both the Senate and House Committees by Professor Henry C. Wallich are of particular moment for they bring into focus the issue in

this case. Referring to the consequences of the repeal of Section 22(d), which he favored, he observed:

> "It is claimed that a 'bootleg', i.e., free market would then arise in which investors wishing to redeem could sell their shares at slightly more than the current market value which the fund itself offers. The shares would then be resold for less than what the fund would charge (including sales load). Such a market which would be perfectly legitimate, would obviously be beneficial both to investors who redeem and who purchase. The fund would lose the sales load on the shares turning over in the market instead of being reissued by it . . . the availability of shares in the market would drive down the sales load . . ." (1967 House Hearings, p. 586; to the same effect, 1967 Senate Hearings p. 1064.)[43]

A proposal to repeal Section 22(d) was embodied in a bill introduced in 1969 by Senator McIntyre, one of the members of the Senate Committee. S. 296, 91st Cong., 1st Sess., § 12(a). Senator McIntyre stated that his bill "would permit commission levels to be established by the free interplay of competitive forces in the open market." 1969 Senate Hearings, p. 5.[44]

In response to questioning by Sen. McIntyre, a Commission spokesman stated:

> "We are told that widcatting and price cutting will be ruinous to the industry. It might well be.

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[43] Repeal of Section 22(d) was also proposed by others. 1967 Senate Hearings, pp. 667-670, 731, 1018.

[44] A committee staff report summarized this provision in Senator McIntyre's bill as follows: "Repeals sec. 22(d) of the Investment Company Act. Sec. 22(d) allows mutual fund distributors and underwriters to fix sales commissions at a set price and makes it a Federal crime for any broker-dealer to sell these shares at a lower price. Repeal of Section 22(d) would allow the competitive forces of the market place to determine mutual sales commissions." 1969 Senate Hearings, p. 4.

> We don't know the answers to those questions and to those possible results. It is because of that area of darkness that we just didn't feel we had enough economic background and strength to come up here and recommend a repeal of this section." (1969 Senate Hearings, pp 18-19)

This too was the position taken by the Commission in its presentation on sales loads during the 1969 House Hearings, pp. 183, 864, 901.

Instead of sales charges being determined by competition, the Congress, as the Senate Committee pointed out,

> "... decided to rely on the existing self-regulatory machinery of the securities industry in order to protect public investors against unreasonable sales charges subject to appropriate Securities and Exchange Commission oversight." Senate Report, p. 7.

This was reiterated in the House Report (pp. 4-5).

The Senate Report (pp. 7-8), and also the House Report (p. 3) in practically verbatim language, stated:

> "The basic sales commission charged for mutual fund shares . . . is protected by Section 22(d) of the Investment Company Act which provides for a unique scheme of retail price maintenance. Under this section, all dealers, regardless of the source of the shares they sell, are prohibited by law from cutting the sales charge fixed by the mutual fund underwriter. Price cutting in this field is a Federal crime."

The Senate Report in this connection pointed out (p. 8) that shares of "particular mutual funds are not sold on a 'bid and asked basis' as are other securties offered and sold in the competitive over-the-counter market."

The two committee reports further pointed out that under the amendment " . . . sales loads fixed by the principal underwriters . . . continue to be protected against price competition by section 22(d) of the Act . . ." Senate Report, p. 18; House Report, p. 30.

Yet the premise of appellant's complaint is that sales charges are not determined by competition.

The Senate Committee in its report stated (p. 8) that it had considered repealing Section 22(d), but that there was impressive testimony that there had not been sufficient study of the consequences of repeal. The committee requested the Commission to prepare a report on the subject. The Commission staff prepared such a report.[45] Thereafter, the Commission held public hearings on the subject.[46] Appellant appeared to advocate repeal.[47] As the Commission's chairman pointed out in the speech referred to earlier, the Commission is in the process of formulating recommendations. Meanwhile, to implement the provisions of the amended Section 22(b), the NASD, after extensive economic studies, has informally proposed rules which have been submitted to the Commission for its consideration.[48]

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[45] Report of the Staff of the Securities and Exchange Commission on the Potential Economic Impact of a Repeal of Section 22 (d) of the Investment Company Act of 1940 (November 1972).

[46] In the Matter of Mutual Fund Distribution and the Potential Impact of the Repeal of Section 22(d) of the Investment Company Act of 1940, File No. 4-164.

[47] *Ibid.*, pp. 2019 ff.

[48] Investment Company Act Release No. 7475 (November 3, 1970), pp. 2-3.

In view of the foregoing, we submit that appellant's approach in attacking the NASD is simply an unwarranted assault on the pattern of regulation established by the Congress.

CONCLUSION

The motion to affirm should be granted.

Respectfully submitted,

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APPENDIX

Distribution, Redemption, and Repurchase of Redeemable Securities.

Sec. 22. (a) A securities association registered under section 15A of the Securities Exchange Act of 1934 may prescribe, by rules adopted and in effect in accordance with said section and subject to all provisions of said section applicable to the rules of such an association—

(1) a method or methods for computing the minimum price at which a member thereof may purchase from any investment company any redeemable security issued by such company and the maximum price at which a member may sell to such company any redeemable security issued by it or which he may receive for such security upon redemption, so that the price in each case will bear such relation to the current net asset value of such security computed as of such time as the rules may prescribe; and

(2) a minimum period of time which must elapse after the sale or issue of such security before any resale to such company by a member or its redemption upon surrender by a member;

in each case for the purpose of eliminating or reducing so far as reasonably practicable any dilution of the value of other outstanding securities of such company or any other result of such purchase, redemption, or sale which is unfair to holders of such other outstanding securities; and said rules may prohibit the members of the association from purchasing, selling, or surrendering for redemption any such redeemable securities in contravention of said rules.

(b)(1) Such a securities association may also, by rules adopted and in effect in accordance with said section 15A, and notwithstanding the provisions of subsection (b)(8) thereof but subject to all other provisions of said section applicable to the rules of such an association, prohibit its

members from purchasing, in connection with a primary distribution of redeemable securities which any registered investment company is the issuer, any such security from the issuer or from any principal underwriter except at a price equal to the price at which such security is then offered to the public less a commission, discount, or spread which is computed in conformity with a method or methods, and within such limitations as to the relation thereof to said public offering price, as such rules may prescribe in order that the price at which such security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors. The Commission shall on application or otherwise, if it appears that smaller companies are subject to relatively higher operating costs, make due allowance therefor by granting any such company or class of companies appropriate qualified exemptions from the provisions of this section.

(2) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970, or after a securities association has adopted rules as contemplated by this subsection, the Commission may make such rules and regulations pursuant to section 15(b)(10) of the Securities Exchange Act of 1934 as are appropriate to effectuate the purpose of this subsection with respect to sales of shares of a registered investment company by broker-dealers subject to regulation under section 15(b)(8) of that Act: *Provided,* That the underwriter of such shares may file with the Commission at any time a notice of election to comply with the rules prescribed pursuant to this subsection by a national securities association specified in such notice, and thereafter the sales load shall not exceed that prescribed by such rules of such association, and the rules of the Commission as hereinabove authorized shall thereafter be inapplicable to such sales.

(3) At any time after the expiration of eighteen months from the date of enactment of the Investment Company Amendments Act of 1970 (or, if earlier, after a securities association has adopted for purposes of paragraph (1) any rule repsecting excessive sales loads), the Commission may alter or supplement the rules of any securities association as may be necessary to effectuate the purposes of this subsection in the manner provided by section 15A(k)(2) of the Securities Exchange Act of 1934.

(4) If any provision of this subsection is in conflict with any provision of any law of the United States in effect on the date this subsection takes effect, the provisions of this subsection shall prevail.

(c) The Commission may make rules and regulations applicable to registered investment companies and to principal underwriters of, and dealers in, the redeemable securities of any registered investment company, whether or not members of any securities association, to the same extent, covering the same subject matter, and for the accomplishment of the same ends as are prescribed in subsection (a) of this section in respect of the rules which may be made by a registered securities association governing its members. Any rules and regulations so made by the Commission, to the extent that they may be inconsistent with the rules of any such association, shall so long as they remain in force supersede the rules of the association and be binding upon its members as well as all other underwriters and dealers to whom they may be applicable.

(d) No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal under-

writer, or the issuer, except at a current public offering price described in the prospectus. Nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 including any offer made pursuant to section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12.

(e) No registered investment company shall suspend the right of redemption or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security to the company or its agent designated for that purpose for redemption except—

(1) for any period (A) during which the New York Stock Exchange is closed other than customary weekend and holiday closings or (B) during which trading on the New York Stock Exchange is restricted;

(2) for any period during which an emergency exists as a result of which (A) disposal by the company of securities owned by it is not reasonably practicable or (B) it is not reasonably practicable for such company fairly to determine the value of its net assets; or

(3) for such other periods as the Commission may by order permit for the protection of security holders of the company.

The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection. Any company which,

as of March 15, 1940, was required by provision of its charter, certificate of incorporation, articles of association, or trust indenture, or of a by-law or regulation duly adopted thereunder, to postpone the date of payment or satisfaction upon redemption of redeemable securities issued by it, shall be exempt from the requirements of this subsection; but such exemption shall terminate upon the expiration of one year from the effective date of this title, or upon the repeal or amendment of such provision, or upon the sale by such company after March 15, 1940, of any security (other than short-term paper) of which it is the issuer, whichever first occurs.

(f) No registered open-end company shall restrict the transferability or negotiability of any security of which it is the issuer except in conformity with the statements with respect thereto contained in its registration statement nor in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company.

(g) No registered open-end company shall issue any of its securities (1) for services; or (2) for property other than cash or securities (including securities of which such registered company is the issuer), except as a dividend or distribution to its security holders or in connection with a reorganization.